

1 restatement.”

2 83. Brocade announced the results of the restatement on January 24, 2005. The
3 Company restated its financial statements for fiscal years 2002 and 2003 to correct the
4 accounting treatment for stock-based compensation, resulting in an overall reduction in net
5 income of approximately \$304 million for years before 2002.

6 84. Brocade used variable accounting for the restatement, because it concluded that
7 its historical books and records were not sufficiently reliable to permit the use of fixed
8 accounting to determine the compensation expense attributable to improperly granted stock
9 options.

10 85. Brocade also announced on January 24, 2005 that Reyes would step down as
11 CEO.

12 86. The First Investigation had focused only on options-granting activities before
13 August 2003, in part because the Audit Committee and its consultants believed that Brocade had
14 changed its options-granting policies at that time and that no further improprieties had occurred.

15 87. In early March 2005, however, information emerged that “look-back” or
16 backdating practices had in fact been used after July 2003.

17 88. Based on the new information, the Audit Committee and its consultants in May
18 2005 began another investigation of Brocade’s options-granting practices (the “Second
19 Investigation”).

20 89. Brocade also announced on May 16, 2005 that it would restate its financial
21 statements for the fiscal years ending 2002 through 2004 to record additional charges for stock-
22 based compensation expense, because the new information showed (among other things) that
23 Brocade could not rely on the documentation used to support the recorded measurement dates for
24 stock options granted from August 2003 through November 2004.

25 90. The Audit Committee completed the Second Investigation in November 2005,
26 concluding that Brocade had incorrectly accounted for stock-based compensation related to
27 (i) measurement dates for the period August 2003 through November 2004, (ii) employees on
28 leave of absence or in transitional roles before leaving the Company, primarily in fiscal years

1 1999 through 2001, and (iii) recorded dates for certain stock-option exercises.

2 91. The Audit Committee found that, between August 2003 and November 2004, HR
3 personnel had selected grant dates and exercise prices based on the lowest price for the week of
4 the grant, rather than as of the actual grant date. The Committee therefore concluded that the
5 documentation for those grants was unreliable and that Brocade needed to increase its non-cash
6 compensation expense for fiscal 2003 and 2004.

7 92. The Second Investigation also uncovered problems with Brocade's accounting for
8 stock-based compensation for employees on leaves of absence and in advisory roles before
9 leaving the Company.

10 93. On November 14, 2005, Brocade restated its financial statements for fiscal years
11 ending 2002 through 2004 and made adjustments to its financial information for fiscal years
12 1999 through 2001, resulting in an increase in non-cash compensation expense totaling
13 \$72.3 million. The restatement included non-cash stock-based compensation charges of
14 \$900,000 for the process issues in fiscal years 2003 and 2004, \$71 million for the leave-of-
15 absence issues spanning fiscal years 1999 to 2004, and \$400,000 for the exercise-date issues
16 between fiscal years 1999 and 2002.

17 94. The evidence suggests that Brocade's stock-option and accounting problems
18 derailed a merger that the Company was in the process of negotiating with Cisco Systems, Inc.
19 Brocade and Cisco had been nearing agreement on a definitive merger agreement, pursuant to
20 which (according to deposition testimony from Brocade executives) Cisco was going to pay
21 \$9.00 per share for Brocade's approximately 254.5 million outstanding shares of stock (not
22 counting those held by insiders) – a premium of about \$1.85 per share over the stock's market
23 price at the time the deal was expected to close.

24 95. The Audit Committee's investigation and the ensuing events caused the deal to
25 collapse. For example, on November 21, 2004, Andy Johnson e-mailed Reyes that Cisco
26 "essentially want[s] to be able to walk from the deal if the internal investigation causes a
27 restatement or other significant issue. Both sides have indicated this is a deal breaker if they
28 can't get what they want." Reyes responded and agreed that Cisco's stance on the internal

1 investigation “is a deal killer.” Similarly, on November 29, 2004, Reyes e-mailed Canova that:
 2 “If [the internal investigation] goes on until the end of December we can kiss the [Cisco] deal
 3 good bye!”

4 Remedial Actions

5 96. As a result of the two Audit Committee investigations, the Board recommended
 6 and adopted remedial measures. On January 30, 2005, the Compensation Committee resolved to
 7 reprice options granted to Reyes on August 15, 2003 and December 10, 2003, changing the strike
 8 price to the average price of Brocade stock during the fourth quarter of fiscal 2003 and the first
 9 quarter of fiscal 2004, respectively. The strike price of the August 15, 2003 grant of 600,000
 10 options thus was increased from \$5.53 to \$5.82, and strike price of the December 10, 2003 grant
 11 of 500,000 options was increased from \$5.52 to \$6.34.

12 97. The Compensation Committee also approved, ratified, and confirmed the options
 13 that Reyes had granted as a Committee of One (although it did not ratify the conduct underlying
 14 the grants), except for the new-hire grants made to Cudgma, Geruson, Taylor, Daheb, and Traut.
 15 In addition, the Compensation Committee reviewed and later adopted new options-granting
 16 practices that it deemed to be consistent with best practices in the industry.

17 Legal Proceedings and Investigations

18 98. The events described above led to a barrage of legal proceedings and
 19 investigations involving Brocade and its current and former officers and directors, including
 20 (i) criminal prosecutions of Reyes and Jensen by the U.S. Department of Justice, (ii) an SEC
 21 investigation of Brocade, (iii) the SEC’s civil-enforcement actions against Reyes, Jensen, Byrd,
 22 and Canova, (iv) federal- and state-court securities-law class actions, and (v) federal- and state-
 23 court shareholder derivative actions.

24 Criminal Prosecutions and Convictions

25 99. The Department of Justice filed a criminal complaint against Reyes and Jensen on
 26 July 20, 2006, and the two were indicted on August 11, 2006.

27 100. On August 7, 2007, a jury in this Court convicted Reyes on ten counts of criminal
 28 activity: (i) criminal conspiracy, (ii) securities fraud, (iii) three counts of making false SEC

1 filings through Brocade's Forms 10-K for the fiscal years ended October 27, 2001, October 26,
2 2002, and October 25, 2003, (iv) falsifying books, records, and accounts, (v) two counts of
3 making false statements to an accountant in management representation letters for the fiscal
4 years ended October 26, 2002, and October 25, 2003, and (vi) two counts of making false
5 statements to an accountant in certifications filed with the Forms 10-K for those fiscal years.

6 101. On January 16, 2007, the Court sentenced Reyes to 21 months in prison and a
7 \$15 million fine. The sentence included four extra months that the Court added based on Reyes'
8 having submitted a false declaration to the Court in connection with Jensen's motion to sever her
9 trial from Reyes'. Reyes had sworn to the Court that the two trials should be severed because no
10 options backdating had occurred and because he intended to testify in Jensen's favor at her trial.
11 After the Court granted the severance motion, however, Reyes essentially conceded at his own
12 trial that backdating had in fact occurred – and he did not testify at Jensen's trial.

13 102. In connection with Reyes' sentencing, Brocade asked the Court to order Reyes to
14 pay restitution to the Company, including costs related to Brocade's internal investigations of the
15 historical stock-option practices, the SEC investigation and settlement, and the defense of civil
16 proceedings – totaling \$37,570,939.76 – plus an additional \$64,478,039 for defense costs the
17 Company had advanced to directors, officers, and employees (mostly to Reyes) in connection
18 with those matters. The Court denied Brocade's request, citing the Company's ability to seek
19 recovery of those costs in the pending derivative litigation.

20 103. On December 5, 2007, Jensen was convicted of (i) conspiracy to falsify books,
21 records, and accounts, in violation of 18 U.S.C. § 371, and (ii) falsifying books, records, and
22 accounts, in violation of 15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(5), and 78ff, and 17 C.F.R.
23 § 240.13b2-1. The Court sentenced Jensen to a four-month prison term on March 19, 2008.

24 104. Brocade asked the Court to order Jensen to pay restitution for the same categories
25 of damages the Company requested from Reyes. The total amount requested was
26 \$104,478,604.51, with \$66,827,664.75 of that amount representing fees and expenses advanced
27 to directors, officers, and employees. The Court denied Brocade's request.

28

SEC Investigation of Brocade

105. In 2005, the SEC informed Brocade that it was conducting a formal investigation, captioned *In re the Matter of Brocade Communications Systems, Inc.*, File No. SF-02932, concerning Brocade's stock-option granting practices. Brocade cooperated with the SEC's Division of Enforcement and produced substantial numbers of documents.

106. Brocade began settlement discussions with the Staff of the Division of Enforcement and recorded \$7 million for an estimated settlement expense for the fiscal quarter ended January 28, 2006. The SEC approved the settlement on May 31, 2007, and the Court entered a final judgment approving the settlement on August 27, 2007. Brocade paid the \$7 million settlement amount on August 31, 2007.

SEC Civil Enforcement Actions Against Reyes, Jensen, Canova, and Byrd

107. The SEC currently is pursuing civil enforcement actions against Reyes, Jensen, Canova, and Byrd in this Court for violating the federal securities laws. The SEC brought the action against Reyes, Jensen, and Canova on July 20, 2006, and sued Byrd separately on August 17, 2007. The cases have now been consolidated and are proceeding.

Securities Class Actions

108. **Federal Securities Class Actions.** Beginning in May 2005, several federal securities class actions were filed in this Court against Brocade and certain of its then-current and former officers on behalf of shareholders who had purchased Brocade stock when the market price allegedly was inflated as a result of Brocade's false financial statements. The consolidated complaint asserted claims under §§ 10(b) and 20(a) of the Exchange Act and alleged that Brocade and the individual defendants had made false or misleading public statements about Brocade's business and operations. The Court denied Brocade's and certain other defendants' motions to dismiss.

109. On October 12, 2007, the Court certified a class of all purchasers of Brocade stock from May 18, 2000 through May 15, 2005, and partially granted the class plaintiffs' motion for partial summary judgment against Reyes, prohibiting him from relitigating the criminal jury's finding that he knowingly and willfully had made material misrepresentations in

1 Brocade's Forms 10-K for 2001, 2002 and 2003.

2 110. On May 13, 2008, the Court granted plaintiffs' motion for partial summary
3 judgment that Reyes had been acting within the course and scope of his employment at Brocade
4 when he signed Forms 10-K for fiscal years 2001 through 2003.

5 111. In light of the Court's rulings and other factors relating to the litigation, Brocade
6 agreed on May 30, 2008 to settle the federal class action for \$160 million.

7 112. **State Securities Class Action.** On October 23, 2007, a putative class-action
8 complaint captioned *Huang v. Reyes* was filed against Brocade and certain of its current and
9 former officers and directors in the California Superior Court, Santa Clara County, on behalf of
10 persons who owned Brocade stock between February 21, 2001 and May 16, 2005. The
11 complaint (which actually appears to be a disguised derivative action) alleges that Brocade and
12 the individual defendants breached their duty of disclosure by failing to disclose the conduct at
13 issue in the federal securities litigation. The case is currently being litigated.

14 Shareholder Derivative Actions

15 113. Beginning in May 2005, several putative shareholder derivative actions were filed
16 in the California Superior Court, Santa Clara County, alleging claims for breach of fiduciary duty
17 and various other state-law claims against certain of Brocade's current and former officers and
18 directors based largely on the same factual allegations underlying the federal class actions. The
19 cases were assigned to the Honorable Jack Komar, in the court's Complex Litigation
20 Department, and were consolidated as *In re Brocade Communications Systems Derivative*
21 *Litigation*, No. 1:05CV041683.

22 114. Beginning in June 2005, several additional putative shareholder derivative actions
23 were filed in this Court alleging claims similar to those asserted in the state-court derivative
24 suits, as well as a federal claim under § 20(a) of the Exchange Act. The Court related the federal
25 derivative actions to the pending securities class actions and consolidated the derivative actions
26 under the caption *In re Brocade Communications Systems, Inc. Derivative Litigation*, No. C05-
27 02233 CRB.

28 115. On January 6, 2006, the Court dismissed the consolidated federal derivative

1 actions based on the plaintiffs' failure to plead with sufficient particularity why a pre-suit
 2 demand on Brocade's Board would have been futile. The federal plaintiffs then made a demand
 3 on the Board on January 13, 2006.

4 116. In response to the federal plaintiffs' demand, Brocade entered into settlement
 5 discussions with the plaintiffs, and the parties reached an agreement to settle the federal
 6 derivative actions. The Court preliminarily approved the proposed settlement on February 14,
 7 2007, but declined to grant final approval at the fairness hearing on April 27, 2007, after the
 8 federal plaintiffs expressed their unwillingness to proceed with the settlement in light of the
 9 confirmatory discovery they had undertaken.

10 117. The parties then engaged in certain motion practice in the consolidated state-court
 11 derivative action, although – pursuant to the parties' agreement – the state court deferred ruling
 12 on most of the pending motions. The parties also participated in mediation sessions with Judge
 13 Komar on September 27, 2007, November 14, 2007, and February 8, 2008, but were unable to
 14 reach a settlement.

15 118. Another federal putative shareholder derivative action – *Barbour v. Reyes*,
 16 No. 08-02029 CRB – was filed in this Court on April 15, 2008. The case has been related to, but
 17 not consolidated with, the consolidated federal derivative action.

18 119. **Section 16(b) Action.** Yet another putative shareholder derivative action,
 19 captioned *Roth v. Reyes*, was filed in this Court on April 24, 2006 against Brocade (as a nominal
 20 defendant) and four former officers, including Reyes, Byrd, Canova, and Cuthbert, alleging
 21 violations of § 16(b) of the Exchange Act and seeking to recover “short-swing” trading profits.
 22 The Court dismissed the action on August 27, 2007. Plaintiff has appealed the dismissal to the
 23 Ninth Circuit.

24 Appointment of SLC

25 120. On February 22, 2008, after settlement efforts in the federal and state derivative
 26 actions had stalled, Brocade's Board of Directors appointed the SLC to handle all matters
 27 relating to the derivative litigation. The Board delegated to the SLC “plenary authority to decide
 28 whether it is in the best interests of the Company and its shareholders to pursue or otherwise